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No. 84-613

IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

EMI LIMITED,

Petitioner,

v.

WILLIAM BENNETT, AND ERNEST J. DRONENBURG, JR., SUCCESSOR; KENNETH CORY; RICHARD SILBERMAN, AND MARY ANN GRAVES, SUCCESSOR; AND MARTIN HUFF AND GERALD H. GOLDBERG, SUCCESSOR,

Respondents.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF OF THE UNITED KINGDOM AS *AMICUS CURIAE* SUPPORTING CERTIORARI

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Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF OF THE UNITED KINGDOM AS *AMICUS CURIAE* SUPPORTING CERTIORARI[1]

INTEREST OF *AMICUS CURIAE*

Petitioner's briefs in the proceedings below cover a wide spectrum of issues relating to the constitutionality of applying a unitary state income tax to a U.S. subsidiary of a U.K. parent corporation. The British Government

[1] Petitioner and respondents have filed letters with the Clerk of this Court consenting to the filing of this *amicus curiae* brief.

has repeatedly and forcefully objected to the imposition of such taxes.[2]

This *amicus* brief is being filed for the more limited purpose of urging the Court to resolve a question involving standing that also has major international ramifications. Simply put, the question is whether a British parent corporation has standing in the U.S. Federal courts to challenge the constitutionality of demands made by a taxing State for the production of financial data relating to the worldwide operations of the parent and its foreign subsidiaries, none of whom is doing business in the taxing State or elsewhere in the United States.

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[2] During Prime Minister Thatcher's visit with President Reagan in September, 1983, the Prime Minister said that "something will have to be done" to limit the effects of the unitary tax, adding that Britain considers the issue "serious." N.Y. Times, Sept. 30, 1983, § A, at 3, col. 1. Copies of the following documents, which express the United Kingdom's opposition to the unitary tax, are reproduced in Appendix A, *infra:*

(a) Note Submitted to the Department of State by the Member States of the European Community (including the United Kingdom), the European Commission and the Embassies of Australia, Canada, Japan and Switzerland for the Attention of the U.S. Treasury Working Group on Worldwide Unitary Taxation (App. 1a).

(b) Statement of the Government of the United Kingdom Before the U.S. Treasury Working Group on Worldwide Unitary Taxation (App. 3a).

(c) Letter Dated July 12, 1983 from the Chancellor of the Exchequer to the Secretary of the Treasury (App. 19a).

(d) Note Submitted by the United Kingdom to the Department of State dated May 18, 1982 (App. 21a).

(e) Note Submitted by the United Kingdom to the Department of State dated October 30, 1981 (App. 23a).

(f) Note Submitted by the United Kingdom to the Department of State dated March 25, 1980 (App. 26a).

As discussed below, the burden of such requests falls squarely on the British parent corporation. Nonetheless, the decision below leaves the parent corporation without any forum in which to challenge the imposition of this burden.

Businesses headquartered in the United Kingdom have made direct investments in the United States of over $23 billion, which is more than the amount invested by any other nation.[3] Because of the extensive U.K. investment in the United States, the participation by U.K. corporations in business activities involving both the United States and third countries, and the adverse impact that the decision below will have on those activities, the British Government has a significant interest in the disposition of this petition for certiorari.

SUMMARY OF ARGUMENT

The standing argument being made in this case is distinctly different from the standing arguments raised in other cases where foreign parent corporations have attacked the constitutional validity of unitary state income taxes.

Petitioner has alleged that California's request for worldwide financial data threatens to injure petitioner in two ways. First, petitioner has alleged that delivery of some of the requested information to California would violate the British Official Secrets Act and would subject petitioner's executives to criminal penalties. Second, petitioner has alleged that much of the requested information is not readily available. For purposes of this proceeding, petitioner's allegations must be accepted as

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[3] Bureau of Economic Analysis, United States Department of Commerce, *Foreign Direct Investment in the United States in 1982*, 63 Survey of Current Business 31, 36 (Aug. 1983, No. 8).

true under this Court's decision in *Warth* v. *Seldin*, 422 U.S. 490, 501 (1975).

The burden imposed on petitioner by a request for information which is not readily available, and the threat of criminal penalties if some of that information is produced, give petitioner an immediate and significant personal stake in this proceeding. By its very nature, the request for financial data relating to petitioner and its non-U.S. subsidiaries can be satisfied only by petitioner. Because the *burden* of complying with the request falls on petitioner, not on its U.S. subsidiary, petitioner rather than the U.S. subsidiary is the proper party to assert that the request imposes a constitutionally impermissible burden on foreign commerce.

It is no answer to say, as the court below did, that petitioner can avoid the burden by declining to comply with the request. As the court below acknowledged (Pet. App. A-6), such action would result in a "threatened increase" in the California tax otherwise payable by petitioner's U.S. subsidiary under California's unitary system. This "threatened increase" in the tax properly payable by the subsidiary under California law constitutes, in substance, a threatened tax on petitioner to force compliance. Thus, petitioner is threatened with harm whether or not it complies. Moreover, the threatened injury is not one that can be adequately avoided in subsequent proceedings brought by the U.S. subsidiary to test the constitutionality of the unitary tax as applied to the subsidiary.

The conclusion that petitioner has standing to seek relief from the injuries threatened here is reinforced by considerations of international law and comity. The international friction that has already been generated by information requests of the type involved here will be exacerbated if the United States shuts the doors of its

courts to the foreign parent companies adversely affected by such requests. Because the foreign parents are the real parties in interest, they should be afforded an opportunity to argue the merits of their own constitutional assertions.

ARGUMENT

I. This Case Differs From Prior Cases In Which Foreign Parent Companies Have Asserted Standing To Challenge Unitary State Income Taxes.

The standing argument presented in this case is entirely different from the standing arguments advanced unsuccessfully in *Shell Petroleum, N.V.* v. *Graves*, 709 F.2d 593 (9th Cir. 1983), *cert. denied*, 464 U.S. ____, 78 L.Ed.2d 717 (1983), and *Alcan Aluminum Ltd.* v. *Franchise Tax Bd. of Cal.*, 558 F.Supp. 624 (S.D.N.Y. 1983), *aff'd mem.*, 2d Cir., *cert. denied*, 464 U.S. ____, 79 L.Ed. 2d 170 (1984). In those cases, the foreign parent corporations based their standing arguments on allegations that California was, in effect, subjecting the foreign parents' separate income to multiple taxation. Standing was denied on the ground that California was taxing only the income of the U.S. subsidiary corporations, with the result that each parent corporation's harm was only that of a shareholder whose investment in its corporation was being diminished in value.[4]

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[4] In addition, jurisdiction was denied in the *Shell* case, *supra*, and *Alcan Aluminium* v. *Department of Rev. of State of Or.*, 724 F.2d 1294 (7th Cir. 1984) on the separate ground that the actions were not ripe. The issue of ripeness is not present in this case since California already has assessed a tax against petitioner's U.S. subsidiary, Capitol Industries-EMI, Inc. ("Capitol").

Similarly, the fact that petitioner's prior petitions for certiorari have been denied should have no bearing here. Those petitions were filed before the decision below by the court of appeals in an effort to join this case with other cases involving unitary issues then pending before this Court.

By contrast, petitioner's standing argument here is based on the uncontested fact that petitioner *itself* will be directly burdened as a consequence of California's request for detailed financial information covering petitioner and its worldwide non-U.S. subsidiaries.[5] This standing argument was not presented to the Court in the other cases in which certiorari was denied. In particular, the *Shell* and *Alcan* cases, *supra*, did not involve any threatened violation of foreign law that might subject the petitioners' employees in those cases to criminal penalties.

Moreover, to the extent that the standing argument being made here was adverted to in the other cases, the clear suggestion was that standing would be established if the foreign parent made an adequate factual showing of its harm. For example, in *Alcan Aluminium* v. *Department of Rev. of State of Or.*, *supra*, the court of appeals distinguished *Shell*, stating (724 F.2d at 1299):

> In *Shell*, however, the parent's only alleged injury was as a shareholder of its subsidiary. The parent alleged no independent injury as a basis for standing. *Id.* at 595. Thus, the subsidiary's state remedy fully protects the parent's interests. The present case is distinguishable. Appellant has alleged an independent injury as a basis for standing. It claims an unconstitutional burden on its foreign commerce. If

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[5] Petitioner's complaint in the district court alleged in Count VI that "Much of the information requested [by California] is not published by or readily available to EMI." For purposes of deciding the standing issue, these allegations must be accepted as true. *Warth* v. *Seldin*, *supra*, 422 U.S. at 501. Obviously, a request to furnish information that is not readily available places a direct burden on petitioner. Moreover, as discussed at p. 9, *infra*, compliance with California's request could subject petitioner's employees to possible criminal penalties in the U.K. Thus, the threatened harm to petitioner is twofold.

> appellant's allegations as to its standing are accepted as true, its interests and those of Alcancorp are not identical. *See also Capitol Industries-EMI, Inc.* v. *Bennett*, 681 F.2d at 1118-19 & n.30. Thus, Alcancorp's state remedy does not protect appellant fully. As soon as the tax is assessed against Alcancorp, the threat of injury to appellant will be immediate. Nothing in the Tax Injunction Act requires appellant to wait while Alcancorp pursues its own remedies under Oregon law for its own injury.

See also Alcan Aluminum Ltd. v. *Franchise Tax Bd. of Cal., supra*, 558 F.Supp. at 628 n.9.

The clear suggestion by the court of appeals that Alcan would have standing once its case was ripe is in apparent conflict with the decision below. This Court should consider the standing issue presented here in order to resolve the conflict on an issue having obvious and important international implications.

II. The Potential Injuries To Petitioner In This Case Give Petitioner Standing To Challenge The Constitutionality Of California's Request For Worldwide Financial Data of Corporations Doing No Business In California.

1. The court of appeals erred in holding that petitioner lacks standing. The critical error was the court's conclusion (Pet. App. A-6) that ". . . EMI's only possible injury is the diminution in value of its holdings in Capitol."

To the contrary, petitioner has alleged its own, personal harm that is separate and distinct from the tax liability assessed by California against Capitol. Petitioner's own direct harm is twofold. First, the burden of generating the worldwide financial data requested in this and other similar cases is substantial in terms of time, effort and cost. Generally the data do not exist as such, but must be especially generated, and then converted into dollars at

differing current and historical exchange rates. Separate sets of computations may have to be made for different States that apply different accounting standards.[6] EMI has 63 non-U.S. subsidiaries that would be covered by California's request in this case. Other U.K. parents affected by similar requests have well over 100 such subsidiaries. Her Majesty's Government believes that it imposes an intolerable burden on foreign commerce to require a United Kingdom parent company to obtain and deliver to the California tax authorities detailed financial data, stated in U.S. dollar terms, for scores of worldwide subsidiaries that do *no business* in California or elsewhere in the United States and have *no business contacts* with the U.S. subsidiary that does do business there.[7]

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[6] The problem of trying to convert the books and records of a worldwide business conducted by a U.K. parent corporation into figures computed in U.S. dollars on the basis of U.S. tax and accounting principles is clearly set forth in the comments submitted by the Confederation of British Industry to the U.S. Working Group on Worldwide Unitary Taxation (Dec. 1983). Those comments are reproduced in Appendix A, *infra* (App. 30a).

[7] By contrast, Federal tax law requires that domestic subsidiaries of foreign parents provide information only with respect to those foreign affiliates that had a "transaction with" the reporting domestic company; moreover, the information that must be furnished in those cases is limited to readily available information regarding the foreign affiliate and the transactions conducted with it. See Internal Revenue Code, section 6038A. Thus, California is here seeking worldwide financial data that goes far beyond the limited *transactional* data that must be furnished to comply with Federal law. The British Government believes that U.K. parent companies directly affected by sweeping state requests of the type involved here have standing to assert that the marked difference between the state and Federal requirements confirms the conclusion that the state requirements impose a constitutionally impermissible burden on foreign commerce.

In addition to being burdensome, California's request for information could expose petitioner's employees to possible criminal penalties in the U.K. Petitioner's complaint in this case alleges in Count VII that "Some of the information sought is protected from disclosure by the British Official Secrets Act and by similar legislation in other countries, and were it to be divulged, to Defendants' staff or to others, EMI's executives would become liable to criminal proceedings in the United Kingdom and other countries."

Surely, the possibility that delivery of the documents might lead to criminal sanctions against petitioner's own employees gives petitioner standing to assert in the Federal courts that the demand for delivery made by California is an unconstitutional restraint on foreign commerce. Petitioner's threatened injury is "distinct and palpable." *Warth* v. *Seldin*, *supra*, 422 U.S. at 501.

There should be no question that *standing* to raise the issue exists when one recognizes that, on its *merits*, the issue is a serious one involving "a sensitive balancing of the competing interests at stake." *United States* v. *First Nat. Bank of Chicago*, 699 F.2d 341, 345 (7th Cir. 1983).

2. Petitioner is the real party in interest in this proceeding. California originally directed its demand for information to petitioner and only belatedly redirected the demand to Capitol. Even in cases where demands for worldwide financial data are originally addressed to the subsidiary doing business in the taxing State, the taxing authorities must know that compliance will require parent company action. There is no conceivable way that a California subsidiary is going to be able to obtain data from its foreign parent company or from other foreign subsidiaries unless the common parent undertakes to make such data available. Because the *burden* of complying falls on the foreign parent, not on the domestic sub-

sidiary, it is the parent and not the subsidiary who should have standing to seek declaratory judgment relief.

3. It is no answer to say, as the court below did (Pet. App. A-6), that petitioner itself will suffer no direct harm if it chooses not to comply with California's demand for worldwide financial data. If that happens, California will make arbitrary assumptions which will *increase* the tax that would otherwise be payable by Capitol under California's unitary method. This "threatened increase," which the court below recognized (Pet. App. A-6), will in form be assessed against Capitol. But the increment in tax attributable to petitioner's refusal to supply information will in reality be a tax on petitioner to force its compliance. Thus, the cases cited by the court below (Pet. App. A-6), involving shareholders whose only interest was a threatened diminution in the value of their stock, are simply not in point. In each of those cases, the potential harm to the subsidiary arose solely as a consequence of its own separate actions and did not reflect indirect pressure being exerted to compel certain action by the parent corporation.

The alternative harms to petitioner are obvious. Petitioner is faced with "immediate business costs" if it complies with California's request or "immediate coercive consequences" if it does not. *Nuclear Engineering Co.* v. *Scott*, 660 F.2d 241, 252 (7th Cir. 1981), *cert. denied*, 455 U.S. 993 (1982).

4. It has already been established that "California does not provide [petitioner] with an effective state remedy for its claims." *Capitol Industries-EMI, Inc.* v. *Bennett*, 681 F.2d 1107, 1119 (9th Cir. 1982), *cert. denied*, 459 U.S. 1087 (1982). Thus, if the decision below is permitted to stand, petitioner will be foreclosed from all judicial review.

The decided case closest in principle to the present one is this Court's recent decision in *South Carolina* v. *Regan*, 465 U.S. ____, 79 L.Ed. 2d 372 (1984) in which the Court held that jurisdiction was not barred by the Anti-Injunction Act where the party aggrieved would not otherwise have access to judicial review. The Court rejected the possibility that South Carolina's interest in that case could adequately be advanced in suits brought by third-party taxpayers. The result should be the same here.

It is highly doubtful whether Capitol will ever have standing to advance petitioner's separate constitutional claims. See *South Carolina* v. *Regan*, *supra*, 79 L.Ed. 2d at 383. But even if such standing does exist, petitioner's objection to California's information request cannot adequately be pursued in proceedings brought by Capitol since that route will entail heightened risks to Capitol.

If Capitol attempts to litigate the constitutionality of California's request for information after petitioner has refused to comply, Capitol will face a "threatened increase" in tax (Pet. App. A-6) and possible penalties (Petitioner's Complaint, Count VI) by reason of such refusal. In this respect, the present case is analogous to *National Restaurant Ass'n* v. *Simon*, 411 F.Supp. 993 (D. D.C. 1976) where the court held that the Anti-Injunction Act did not prevent the plaintiff-employer from seeking an injunction against enforcement of an Internal Revenue Service ruling requiring employers to report certain tips paid to their employees. The Government argued that the court lacked jurisdiction to consider injunctive relief because the plaintiff could test the validity of the reporting requirements by failing to report the tips and contesting the $1 fine which the Government could impose for each such failure. The court rejected the Government's argument on the ground that it put the

plaintiff in the "untenable position" of risking a fine "merely to test the validity of a reporting and information requirement." (411 F.Supp. at 996). That is precisely the position Capitol would be in if it attempted to test the validity of California's request for information in this case.

Given the international implications of this case, *amicus* wishes to point out that the court of appeal in England came to a similar conclusion in *Dyson* v. *Attorney-General*, 1 K.B. 410 (1911). In that case, the court held that a taxpayer who was threatened with penalties if he failed to comply with a request for tax information could bring a declaratory judgment proceeding against the Attorney General to test the validity of the request. In his opinion, Farwell L. J. stated (1 K.B. at 421):

> It is obviously a question of the greatest importance; more than eight millions of Form IV. have been sent out in England, and the questions asked entail much trouble and in many cases considerable expense in answering; it would be a blot on our system of law and procedure if there is no way by which a decision on the true limit of the power of inquisition vested in the Commissioners can be obtained by any member of the public aggrieved, without putting himself in the invidious position of being sued for a penalty.

III. The Federal Courts Should Exercise Jurisdiction In Cases Such As This Involving Questions Of International Law And Considerations Of Comity Among Nations.

This Court has considered the question of standing in numerous contexts. See, *e.g.*, *Warth* v. *Seldin*, *supra*; *United States* v. *SCRAP*, 412 U.S. 669 (1973); *Flast* v. *Cohen*, 392 U.S. 83 (1968). "This inquiry involves both constitutional limitations on federal-court jurisdiction and prudential limitations on its exercise." *Warth* v. *Seldin*, *supra*, 422 U.S. at 498. For the reasons previously

discussed, there should be no question that the threshold constitutional requirement of justiciability has been satisfied in this case.[8] The British Government urges the Court to grant certiorari to decide whether the court below properly exercised the "prudential limitation" on its jurisdiction.

It is well recognized that cases involving requests for information from foreign parties present special issues of international law and comity among nations. *United States* v. *Toyota Motor Corp.*, 569 F.Supp. 1158 (C.D. Cal. 1983), *appeal pending* (9th Cir.); *In re Grand Jury Proceedings*, 691 F.2d 1384 (11th Cir. 1982), *cert. denied sub nom. Bank of Nova Scotia* v. *United States*, 462 U.S. 1119 (1983); *United States* v. *Vetco, Inc.*, 691 F.2d 1281 (9th Cir. 1981), *cert. denied*, 454 U.S. 1098 (1981); *United States* v. *First Nat. Bank of Chicago*, *supra*. Requests of the type made in this case have had, and are continuing to have, an adverse impact on commercial relations between the United States and most of its major trading partners.[9] Foreign parent corporations as well as foreign governments (including *amicus*) believe it is inherently unfair to close the courts of the United States to foreign parents who are seeking to challenge the validity of such requests under the Federal Constitution. Under these circumstances, in a case involving serious questions of foreign relations where the denial of jurisdiction will create "international friction" (*United States* v. *Vetco, Inc.*, *supra*, 691 F.2d at 1388), the Federal courts should exercise their discretion in favor of finding jurisdiction.

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[8] In *Shell Petroleum, N.V.* v. *Graves*, *supra*, the court of appeals acknowledged (709 F.2d at 595) that the decision denying standing "was based on prudential rather than Constitutional grounds."

[9] See n.2, *supra* and *Container Corp.* v. *Franchise Tax Bd.*, 463 U.S. ____, 77 L.Ed.2d 545, 577 n.4 (1983) (Powell, J., dissenting).

CONCLUSION

This case affords the Court an opportunity to consider the constitutionality of unitary taxation in the foreign parent context, a question left unanswered in *Container Corp.* v. *Franchise Tax Bd.*, 463 U.S. ____, 77 L.Ed. 2d 545 (1983). The British Government is anxious to have that issue resolved. But even if the Court chooses not to answer all of the important issues in this case at this time, *amicus* strongly urges that the Court at least grant certiorari in order to consider the important, separate question of standing.

Respectfully submitted,

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APPENDIX

APPENDIX A

NOTE SUBMITTED TO THE DEPARTMENT OF STATE BY THE MEMBER STATES OF THE EUROPEAN COMMUNITY (INCLUDING THE UNITED KINGDOM), THE EUROPEAN COMMISSION AND THE EMBASSIES OF AUSTRALIA, CANADA, JAPAN AND SWITZERLAND FOR THE ATTENTION OF THE U.S. TREASURY WORKING GROUP ON WORLDWIDE UNITARY TAXATION

The Embassies of the Member States of the European Community, the European Commission and the Embassies of Australia, Canada, Japan and Switzerland present their complements to the Department of State. A copy of this Note is also being delivered to the Department of the Treasury for the attention of the Working Group on Worldwide Unitary Taxation.

Our countries constitute the United States' main trading partners, accounting for more than half of US trade. We also account for approximately $76 billion of direct investment in the United States (84% of the total) and US direct investment in our countries amounts to $154 billion (69% of total US direct investment abroad). Our governments are all deeply concerned about the use of the worldwide unitary basis of taxation in some individual States of the United States of America and have submitted our views to the Working Group set up by the President and chaired by the Secretary of the Treasury, Donald T. Regan.

At this time, when the Task Force is nearing the completion of its work, we reiterate our concern that the Working Group itself and the US Administration in formulating proposals for action on its recommendations should give full weight to the combined views of the United States' main trading partners so that an internationally-agreed solution to this growing problem

may be implemented quickly thereafter. The achievement of this objective would represent the removal of a serious obstacle to the further development of our trade and investment relationships.

The below-mentioned diplomatic representatives take this opportunity to renew to the Department of State the assurances of their highest consideration.

I append my signature in support of the Joint Note on Unitary Taxation submitted by the Embassy of Belgium.

/s/Ambassador, E and P
British Embassy

Date: 25 January 1984

STATEMENT OF THE GOVERNMENT OF THE UNITED KINGDOM BEFORE THE UNITED STATES TREASURY WORKING GROUP ON WORLDWIDE UNITARY TAXATION

SUMMARY OF PRINCIPAL POINTS

A. Her Majesty's Government is opposed to the application of the unitary method of state taxation on a worldwide reporting basis.

B. The worldwide unitary method of state taxation is contrary to well established international principles and practice of taxation, and imposes unreasonable tax and administrative burdens on multinational corporate groups doing business throughout the world.

C. Unitary taxation is already damaging commercial and economic relations between the US and the UK and other countries. If it continues, the damage to international trading relations will become more serious. If unitary taxation spreads, the scale of the worldwide damage will be further increased.

D. In particular for UK companies unitary tax imposes significant additional burdens on both the companies and their shareholders. First it produces anomalous tax liabilities, which may be considerably larger than those calculated on the internationally-accepted arm's length basis. Second the requirements of the method involve additional compliance costs. In addition the uncertainty generated by the unitary method has disruptive effects on UK corporations' business activities and industrial investment.

E. As long as the worldwide unitary method persists, it will be impossible to achieve the essential economic objectives of providing a consistent and coherent tax framework for international trade and investment.

Moreover, the damage to international trade and investment would be greatly increased if foreign Governments responded by imposing retaliatory measures or introducing unitary systems of their own.

I. INTRODUCTION

1. Almost two years ago, the United States Government advised the Supreme Court in its brief in the *Chicago Bridge & Iron Co* case, that "the imposition of [a state tax] on the apportioned combined worldwide business income of a unitary group of related corporations impairs federal uniformity in an area where such uniformity is essential". That explicit pronouncement of United States policy is equally appropriate for today. Indeed, since that brief was filed, the threat to international business relations posed by the worldwide unitary method of state taxation has assumed even greater magnitude. At present 11 states employ the worldwide combined reporting system, namely Florida, California, Massachusetts, Oregon, Alaska, Idaho, Colorado, Montana, New Mexico, North Dakota and Utah. Approximately 70 per cent of the direct foreign investment in the United States comes from Western Europe. Hence, the burden of the unitary worldwide combined reporting system falls particularly heavily on European based corporations.

2. It is therefore hardly surprising that the unitary tax issue has been the subject of repeated diplomatic protests from other governments since 1979. On August 1, 1983, the 10 governments of the European Community delivered a diplomatic note to the United States Government renewing their objections to the international application of the unitary

tax. Similar objections were expressed by the Japanese Government on August 11, the Netherlands Government on August 17, and the Canadian Government on August 23. Earlier protests against unitary taxation by these governments have been well publicised.

3. The United Kingdom has an interest even stronger than that of other Governments since United Kingdom direct investment in the United States is greater than that of any other country. By 1982 the cumulative total of United Kingdom investment in the United States was $23.334 billion which accounted for 23% of the foreign direct investment in the United States. Any measure which inhibits investment by British business in the United States is clearly to the detriment of both countries. Her Majesty's Government believes that unitary taxation already has a damaging effect on the business relations between the two countries and that the damage will become very serious if the issue is not speedily resolved.

4. The unitary method of taxation is wholly contrary to the agreed international method of attributing the profits of multi-national enterprises between the countries in which they operate. This is the arms-length method which seeks to ensure that profits of such enterprises are allocated in such a manner that each country is able to claim tax on the profits—and no more and no less than the profits—actually earned in that country. If all countries use the same arms-length basis in determining the profits, then double taxation should be avoided through the international net-work of double taxation agreements.

5. Unitary taxation is incompatible with this internationally agreed method. It uses a formula to determine what sum shall be charged and, as practised in the States, it may include profits brought into charge elsewhere on the arms-length basis. If unitary taxation were practised worldwide and every national state could use an identical formula for determining its share of the profits of a multinational enterprise then agreement might be reached internationally on such a basis which would eliminate double taxation. It is, however, the case that over the last 40 years or more the international community has devised and refined the arms-length method for international use. It is in this context of worldwide agreement about the method of attributing profits to multinational companies that the use of a different method by some states of the United States causes a distortion which makes it internationally unacceptable.

6. It is for these reasons that Her Majesty's Government has consistently urged that action be taken to prevent the application of unitary taxation to United Kingdom businesses. It sought to do so when negotiating the current United Kingdom/United States Double Taxation Agreement: but when in 1979, the United States Senate ratified the Treaty it attached a reservation against this provision in Article 9 (4). That Article in its original form would have prevented the United States Government and the individual states from applying the unitary method to United Kingdom corporate groups which have subsidiary companies in the United States. In its final form, the Article applied only for purposes of the United States Federal tax, which does not em-

ploy the unitary method. At the time the United Kingdom, with the approval of Parliament, ratified the amended Treaty and accepted the Senate reservation against Article 9 (4), Her Majesty's Government was given to understand that the Government of the United States would use its best endeavours to eliminate the application of the unitary method of taxation on a worldwide basis. Nevertheless, since then more states have adopted the worldwide unitary approach.

7. Attempts have been made concurrently to secure a solution through the United States courts without success. Last June the United States Supreme Court ruled in *Container Corporation* v. *Franchise Tax Board*, that the California worldwide unitary tax method did not violate the Foreign Commerce Clause of the United States Constitution as applied to a United States parent corporation and its foreign subsidiaries. In so holding, the Court specifically reserved the question of the constitutionality of combined apportionment with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries.

8. In Her Majesty's Government view, the Court's decision in *Container Corporation* was an unfortunate setback that derived, in large measure, from the confusion caused by the failure of the United States Government to reaffirm the position taken in its original brief in the *Chicago Bridge* case, to which we have referred. In considering whether the California tax impaired federal uniformity and the conduct of United States foreign relations, the Court observed that the federal government's failure to file an ami-

cus brief in the *Container* case suggested that "the foreign policy of the United States is not seriously threatened by California's decision to apply the unitary business concept and formula apportionment. . . ." Hence, Her Majesty's Government believes that the outcome of the Court's sharply divided (5-3) decision could well have been different had the federal government clearly restated what all parties originally understood to be its position.

9. Moreover, the likelihood of an early resolution of the applicability of the unitary method to the foreign parent corporation case reserved by the Supreme Court is very much in doubt. Attempts are being made to have the matter heard but two courts of appeal have dismissed suits by foreign corporations against the California Franchise Tax Board on the ground that those foreign entities lack "standing" to contest the tax assessments that are nominally addressed to their domestic subsidiaries. On the other hand, as domestic corporations, the subsidiaries cannot invoke the treaty provisions that are at the heart of the claim that the unitary method impairs the conduct of foreign relations. Hence, these court rulings render rights conferred by treaties unenforceable by the very entities those provisions were negotiated to protect-companies of one treaty party engaged in this way in the territory of the other treaty party.

10. The denial of standing to raise claims under the United States Constitution will leave foreign parent companies which in fact bear the economic burden of double taxation caused by the unitary method unable to challenge the lawfulness of that burden. This may not be "taxation without representation" as it is

usually understood. But it does amount to taxation without the right to be heard, in that a levy whose constitutionality is at issue cannot be challenged by a party directly affected by it. Reciprocally narrow rulings by foreign courts would weaken the ability of the United States companies to obtain judicial protection for their investments abroad.

11. In sum, the failure of both the treaty making process and federal litigation to resolve the validity of the worldwide unitary method makes it imperative that a comprehensive solution be reached as soon as practicable. It is Her Majesty's Government's view that this method is incompatible with the internationally accepted regime for taxing the profits of multinational enterprises.

II. CRITERIA FOR JUDGING A TAX SYSTEM

12. Any tax system should be judged on whether it is capable of being administered equitably, produces certainty and efficiency, and whether it is capable of simple operation. The effects of applying unitary tax on a worldwide basis are both *inequitable* and *uncertain*. Moreover it is *far from simple* for the companies concerned, since it requires a restatement in US terms of the income and formula factors for each component part of a group operating worldwide. These effects in turn constitute an element of *tax induced inefficiency* in the world economy, which will inevitably distort trade patterns and inhibit business decisions.

Application to differing economic circumstances

13. These adverse effects can be traced to particular aspects of applying the unitary basis to the condi-

tions and circumstances which exist today. First, when applied on a worldwide basis, the unitary system is of necessity operating in economic conditions which are far from homogeneous. The system works by combining the income of several related corporations engaged in a "unitary" business. Income is then allocated to the taxing state by multiplying the total income of the enterprise by a percentage comprised of the average of the ratios of instate property, payroll and sales to total property, payroll and sales. The precise formula varies from one State to another.

14. The theory underlying this "unitary" approach is that a dollar of payroll or property spent or a dollar of sales made in one tax jurisdiction produces roughly the same amount of taxable income as a dollar so spent or sales made in another tax jurisdiction. This theory manifestly falls down when applied to two (or more) countries whose economic circumstances are very different. For example, in a developing country property and payroll costs may be very low, relative to those in the United States. On the other hand profits will probably be higher to reflect the risks of expropriation, currency exchange limitations, or other factors. Applying the unitary basis to a group operating both in the USA and a developing country will thus result in a reallocation of group's income from the developing country to the USA. Quite apart from the implications for the group itself (which are discussed in more detail below), it must be open to question whether this represents an equitable division of world resources.

Incompatibility with arm's length basis

15. Second, because international trade relations operate on an entirely different (ie arm's length) basis, the worldwide application of the unitary system produces results which are at best anomalous and at worst give rise to serious inequities. In sharp contrast to the unitary method (see above), the arm's length method requires the income of each corporation to be computed on a separate accounting basis under the assumption that each member of a corporate group must deal with the other members as if they were wholly separate entities owned by unrelated interests. This method has now been recommended by both the OECD and UN model treaty and enshrined in a worldwide network of bilateral treaties to prevent double taxation, including those treaties to which the USA is a party. In addition, following the lead given by the US Federal Authorities in 1928, virtually all developed countries have now adopted the arm's length standard for preventing tax avoidance through artificially fixed intercompany prices.

16. The unitary method and the arm's length method are not compatible. Applying the unitary formula to groups which also operate in countries which work on the arm's length basis leads to cases of double taxation. It has been argued that the unitary basis does not in fact tax the foreign source income of foreign corporations related to the "unitary" company. Instead that income is merely taken into account in order to determine the net income attributable to activity within the "unitary" state. But the arithmetical results of applying a unitary formula belie

this argument. The "unitary" state is in effect requiring a consolidated income tax return and subjecting to tax the income earned by foreign members of the unitary group without giving any relief for overseas tax. In other words it has extended its jurisdiction to bring into its tax net income over which other states will have exercised their priority taxing rights under the normal arm's length arrangements.

17. The element of double counting this involves can and does lead to multinational groups being taxed on more than 100 per cent of their income. This may represent an additional financial cost for the group itself, which is inequitable. Or it could lead to a diminution of the revenues flowing to any exchequer which seeks to avoid double taxation by giving credit for the "unitary" tax paid—a result which at best can be described as anomalous. These inequities and anomalies are particularly acute in the—not uncommon case—where the US company of a unitary group operates at a loss. Even though it had made no profit by any normal commercial standards, the US company would be liable for tax in respect of a proportion of the worldwide profits of its foreign affiliates. In other words there would be an element of direct subsidy from the worldwide group (or foreign revenue as the case may be) to the unitary state.

Unitary basis is not uniform

18. Third the unitary basis is not—and cannot be—uniform in its application. The very concepts it uses are incapable of precise definition, at least on anything other than a very local basis. It is notable that, even amongst the various states within the USA, there are significant variations first in the criteria

used for determining whether or not a particular corporation is "unitary", and second in the formula to be applied to unitary corporations. Even within an individual state it is by no means unknown for a business which has been deemed "unitary" one year to be classed as non-unitary the following year, and for the basis of calculating its tax liability to vary from one year to the next. As a result no business can be sure whether or not it will be adjudged to be "unitary" and if so, how its tax bill will be calculated. In other words the unitary basis breeds uncertainty. The problem this creates for business is heightened by the lack of any procedure analogous to that embodied in "arm's length" tax treaties for resolving disputes about the application of the rules to individual cases.

Unitary basis imposes high compliance costs

19. The fourth aspect of the unitary basis which contributes towards its damaging effects is the compliance costs it involves. It is for the companies themselves to tell the Working Group what complying with the unitary system means in practice. The UK Government would merely note that the full requirements of the system necessitate, at a minimum, the translation into US dollars of accounts maintained by related companies in a multitude of different currencies and the preparation of extra sets of accounts to meet the specific, and varying, requirements of the unitary states. And we understand that the details requested often reflect confidential data, trade secrets, or other information that cannot be made available for reasons totally unrelated to tax considerations.

20. Of more direct concern to the UK Government is the extent to which the unitary states' demands for financial information may involve investigation of the records of UK companies which are outside the USA. More often than not, the substantial majority of the records required describe business transactions that are entirely unrelated to activities within the United States. This is objectionable in principle, as well as producing excessive compliance burdens in practice.

Comparison of unitary method with arm's length method

21. By contrast, the arm's length method, though not perfect, avoids these four very real problems which inevitably arise when the unitary basis is applied worldwide. First by focussing on the amount of profit that would have been made within an individual country by independent parties dealing at arm's length, it recognises that companies operating in different economic circumstances will incur different costs and run very different risks. Second, there is of course no question of the basis being incompatible with internationally-accepted methods—the arm's length basis *is* the international accepted method. Equally, the 'international' nature of the arm's length method helps to avoid the third problem—the lack of any uniform rules. Because it has been for so long the guiding principle of international tax, there has been time to smooth out the 'rough edges' of the arms-length method. The countries of the world have evolved a series of internationally accepted standards which are capable of exact definition under clearly applied procedures. So the various problems identified earlier—of double taxation: of companies being liable to tax on more than 100 per cent of their

income: of companies being liable to tax in respect of profits when, on normal commercial principles, they are making a loss—simply do not arise or where they do, they can be satisfactorily resolved.

22. The fourth problem, that of high compliance costs for companies, equally does not arise to anywhere near the same extent under the arm's length method. The information required in order to operate this method is, more often than not, information which companies have already had to prepare for other purposes. The use of accounts drawn up to comply with company law requirements is a good example of this.

23. Generally, therefore, when measured against the criteria for judging a tax basis the arm's length basis is on each count preferable to the worldwide unitary method. It is at once more equitable, more certain, simpler and more conducive to efficiency. Nor does there seem any good reason why it should not serve as an effective policing mechanism to protect the revenue of individual states. There is an extensive body of Treasury Regulations under Section 482 of the Internal Revenue Code of 1954 providing definitive guidelines governing the fiscal relationships of commonly-controlled corporations. Moreover we understand that, under long-standing accords, information gathered by the United States Treasury from Federal tax audits is continually made available to the individual States. Against this background, the majority of States have felt able to operate an arm's length system, and to apply this rule to subsidiaries of multinational group resident within their jurisdictions.

Wider consequences of the unitary system

24. Any set of rules which fails to measure up to the criteria of a good tax system must be expected to have adverse consequences which go well beyond the immediate impact of that set of rules itself. This is certainly the case with the current application, by several US States, of the unitary system on a worldwide basis.

25. First there is now evidence that it is inhibiting trade relations and distorting investment patterns. In the light of the inequities, anomalies and uncertainties generated by the tax rules, foreign corporations are re-appraising the benefits and burdens of conducting business within a unitary state. The recent decision by the London Chamber of Commerce to cancel its mission to Florida on account of Florida's adoption of the worldwide unitary basis is a good example of this.

26. Furthermore, the spread of unitary taxation amongst the various States can only serve to undermine the very strong position that the United States has adopted in OECD and elsewhere for the liberalisation of international investment flows. The position was restated only a few weeks ago by President Reagan himself in his 9 September Statement on US policy towards international investment. The continued imposition of unitary taxation is incompatible with this stance.

27. These adverse consequences for worldwide trade and investment would be even worse if other countries respond to the States' application of unitary tax by taking retaliatory measures or introducing unitary systems of their own. In particular the States' operation of the worldwide unitary basis, and the US

Federal Government's failure to prohibit this system, may well serve as an example which other countries will soon choose to follow. In particular some developing countries may feel that the system has its attractions for them. If such countries adopt unitary tax, they would be unlikely to follow the three factor formula used, for example, in California. The very different economic conditions which prevail in the developing world would naturally incline them to develop or emphasise factors which allocate a greater proportion of income to the developing country. They might for example focus simply on sales.

28. The effects of other countries taking retaliatory measures, or unitary tax spreading outside the United States, will be keenly felt by the United Kingdom. This is because the UK invests on a substantial scale in foreign countries in both the developed and developing world. But if the UK is a substantial investor in foreign countries, the United States is a much larger one. So the adverse impact on the United States must be expected to be much greater. As things stand at present the economic burden this imposes will, in large part, fall on the United States Federal Government. Because the United State's Internal Revenue Code allows a credit against United States taxes for taxes paid to a foreign country (subject to certain limitations), any increase in foreign taxes could be offset dollar for dollar by a reduction in United States taxes.

III. CONCLUSION

29. In this paper the UK Government has analysed the worldwide unitary system by reference to the universally-accepted criteria of a good tax system—equity, certainty, simplicity and the promotion of economic efficiency. It has demonstrated that, when applied in the present international context, the worldwide unitary method inevitably produces results which are inequitable and uncertain. The method involves additional compliance costs for companies. Furthermore it is in the United Kingdom Government's view objectionable in principle that the method can require the disclosure of the records of companies outside the USA, particularly as these will often apply to transactions entirely unrelated to activities within the United States.

30. If the worldwide unitary system is allowed to persist it will hamper rather than promote economic efficiency distorting investment patterns and inhibiting trade throughout the world. It makes it impossible to achieve the essential objective of providing a consistent and coherent international tax framework for trade and investment. This framework is particularly crucial at the present juncture in the development of the world economy, when businesses are seeking profits throughout the world without regard to national boundaries. The narrow economic standpoint of the unitary system is incompatible with the harmonious relationship that is the goal of our governments, to the benefit of the American and British people alike.

LETTER DATED JULY 12, 1983 FROM THE CHANCELLOR OF THE EXCHEQUER TO THE SECRETARY OF THE TREASURY

Dear Mr. Regan,

I am writing to you on the subject of unitary taxation following the recent decision of the United States Supreme Court in the case of Container Corporation of America v. The California Franchise Tax Board, upholding the right of a state to use the worldwide combined unitary method of taxation. This method carries a high risk of double taxation, and imposes on international companies a heavy administrative burden. As you know this is a subject on which my predecessor and other colleagues have expressed strong views to you on a number of occasions. It is an issue of considerable concern to Parliament and the British business community.

After the filing of an amicus curiae brief in the Chicago Bridge and Iron case by the United States Solicitor General, we advised British companies to await the Supreme Court's decision before making further representations. We were therefore naturally disappointed with the ruling in the Container case. When these issues do arise it seems to us important that an amicus curiae brief is filed, and I wonder whether the lack of such a brief might have been a factor in this case. I appreciate that the latest decision does not apply to United States corporations with foreign parents, which is the issue of most concern to us. However the consequence seems to be that there is little prospect of this particular issue being tested in the Supreme Court in the near future.

I understand that at your meeting on 7 July with the British Ambassador you said that you would probably consider legislative action as a result of the decision. In

the circumstances I would welcome this. Following the reservation of the United States Senate on Article 9(4) of the Double Taxation Convention, there were as you know, some misgivings here, when the Convention came before Parliament for ratification in 1980. Nonetheless ratification was approved in the expectation that action by the Administration to eliminate the practice was in hand.

I should be interested to know how you see this developing, and to learn of your proposed timetable. You will of course be aware that this is a matter where there is strong pressure in Parliament. We are keen for the matter to be resolved as soon as possible before possible harm is done to the good relations between our two countries. I hope we shall have an opportunity to let you have our views on any legislation you may be preparing. Geoffrey Howe, who of course also has a close interest in this subject, will see you in Washington this week and looks forward to having further discussions on this with you.

Yours sincerely,

Nigel Lawson

NOTE SUBMITTED BY THE UNITED KINGDOM TO THE DEPARTMENT OF STATE DATED MAY 18, 1982

Note No. 83

Her Britannic Majesty's Embassy present their compliments to the Department of State and have the honour to refer to their Note of 25 March 1980 to the Department on the exchange of Instruments of Ratification of the Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains.

Her Majesty's Government remains firmly convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory. As was pointed out in that Note this system of taxation makes no attempt to examine the profits made by the locally based subsidiary company. It may look to the total profit of the worldwide operations of the group and claim a proportion of that total by reference to arbitrarily defined criteria. It can lead to a demand for tax by reference to group profits from unconnected activities in other parts of the world where they are already taxed, even though the local subsidiary is incurring substantial losses. In addition the compliance costs are unacceptably high.

Her Majesty's Government wishes to draw the attention of the State Department to the case of Shell Petroleum N.V. v. Graves et al. listed for hearing before the United States District Court, Northern District of California on 1 June 1982, a case which amply illustrates these and other arbitrary and damaging features resulting from

the international application of the unitary basis of taxation with worldwide combined reporting.

Unless common rules accepted by all OECD member States for determining the allocation of profits between different taxing jurisdictions are followed internationally it will be impossible to preserve the essential objective of providing a consistent and coherent international tax framework for business and investment. Her Majesty's Government therefore urges as a matter of high priority that the Government of the United States should use its best endeavours to eliminate the international application of the unitary basis of taxation.

The British Embassy avail themselves of this opportunity to renew to the Department of State the assurances of their highest consideration.

18 May 1982

BRITISH EMBASSY

WASHINGTON

NOTE SUBMITTED BY THE UNITED KINGDOM TO THE DEPARTMENT OF STATE DATED OCTOBER 30, 1981

Note No. 211

Her Britannic Majesty's Embassy present their compliments to the Department of State and, on behalf of the Ten EEC Governments, of which the British Government has now the Presidency, have the honour to forward the attached Note on the problems of the unitary method of taxation.

The British Embassy avail themselves of this opportunity to renew to the Department of State the assurances of their highest consideration.

30 October 1981

BRITISH EMBASSY

WASHINGTON

Attached: Note.

UNITARY TAXATION

1. Our Governments are concerned about the application to US subsidiaries of foreign companies of the unitary basis of taxation as applied in California and in varying degrees by certain other States.

2. The unitary basis makes no attempt to examine the profits generated by the subsidiary. It looks to the total profits of the worldwide operations of the group of which the subsidiary is a part, and claims a portion of those profits on the basis of the assumption that certain specified factors, such as the fixed asset values, turnover and payroll, affect the profits of the subsidiary in the same way and to the same

extent as the profits of the group as a whole, irrespective of where the corporations of the group operate. This means that, whenever the group as a whole makes a profit the subsidiary will be taxed on a portion of this profit, even if the subsidiary is actually making a loss, or in the reverse situation, that the subsidiary may not be taxed if the group as a whole has made a loss, although the subsidiary is actually in a profit making position.

3. This method is incompatible with the principles accepted by all OECD member states and recommended to all states as a basis for the taxation of subsidiaries or permanent establishments of foreign enterprises. These principles require that a subsidiary should be taxed only on the profits it actually has made, provided that these are based on dealing at "arm's length" between the subsidiary and related enterprises, i.e. that the transactions between the subsidiary and related corporations are on the same or on a comparable basis as transactions between wholly independent parties. This is intended to arrive at a fair measure of profit and rule out artificial pricing between members of the group for the sole purpose of minimizing tax liability.

4. Unless the same basic rules for calculating taxable profits are followed generally by the main trading nations it will be impossible to achieve the essential objective of providing a consistent and coherent international tax framework for trade and investment.

5. The unitary tax basis can give rise to obviously inequitable tax liabilities, and to a form of double taxation which often cannot be relieved, or can be

relieved only if countries, which follow generally accepted practices, bear an unfair burden of relief.

6. Unitary taxation, because it requires worldwide reporting of the group's activities in the state where the subsidiary operates, imposes very heavy compliance costs, in addition to the costs of compliance and reporting for non-US corporations in their "home countries."

7. The Federal Government uses the arms-length basis for its taxation of subsidiaries of foreign corporations.

8. The problem was addressed in the US/UK Double Taxation Treaty. Article 9(4) of the Treaty, which was supported by the Administration, would have disallowed the imposition of unitary taxes on subsidiaries of UK companies. When the Senate voted on the Treaty in 1978 the majority approved the Treaty with Article 9(4) in its original form, although the necessary two-thirds majority was not achieved. Subsequently, the Senate approved the Treaty with the necessary two-thirds majority, but subject to the reservation that Article 9(4) was not to apply for the purpose of state taxation. Article 9(4) remained in the Treaty, but only for the purpose of national taxation.

9. There are currently two relevant bills in Congress, S655 and HR 1983.

10. In view of the strong arguments against unitary taxation and the recent extension [of] its application in New York State, our Governments urge you to support this legislation in so far as it relates to the unitary tax issues raised above, with a view to early enactment.

NOTE SUBMITTED BY THE UNITED KINGDOM TO THE DEPARTMENT OF STATE DATED MARCH 25, 1980

Note No. 51

Her Britannic Majesty's Embassy present their compliments to the Department of State and have the honour to refer to the discussions between representatives of the two Governments about the convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains, signed at London on 31 December 1975, as amended by protocols signed at London on 26 August 1976, 31 March 1977 and 15 March 1979 (hereinafter referred to as "the Convention"). It is a matter of regret to her Majesty's Government that difficulties over one aspect of the Convention, although it is an important one, should have tended to obscure the achievement of the two Governments in reaching a fair and balanced agreement.

2. Among double taxation treaties, that between the British and United States Governments has a pre-eminent position. The economic and financial links between the two nations are so strong and the areas covered so diverse that, apart from its intrinsic importance to the United Kingdom and the United States of America, the Convention attracts wide interest internationally and is a source of authority in its field.

3. Her Majesty's Government is therefore gravely concerned that as a result of the amendment resulting from the United States Senate reservation on Article 9(4) the Convention does not comprehensively restrict the application of the unitary basis of taxation. That Article in its

original form would have prevented the United States Government and the individual States of the United States of America from applying this basis to United Kingdom corporate groups which have subsidiary companies in the United States. In its final form the Article applies only for the purposes of United States federal tax, where the unitary basis is not employed, and does not cover individual States of the Union. This is not only a set-back for British corporate investment in the United States. It may also be interpreted as awarding some approval for the unitary basis of taxation and could have wider repercussions.

4. Her Majesty's Government is convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory. The Organisation for Economic Co-operation and Development has explored, encouraged and developed the "arm's-length" principle for regulating the taxation of multinational enterprises operating through subsidiary companies or branches. This principle requires that the subsidiary or branch should be taxed only by reference to the profits which its own activities generate. Where these activities involve transactions with related enterprises and these transactions are not on the basis which would be made between wholly independent enterprises, the profits are to be adjusted for tax purposes by reference to the independent enterprise test ie the "arm's-length" basis. This is intended to achieve a fair measure of the profit by cancelling the effect of any artificial pricing between related enterprises. The "arm's-length" approach has been internationally accepted and is a vital feature of double taxation conventions throughout the world.

5. The unitary basis with combined reporting is a quite

different approach. It makes no attempt to examine the profits made by the locally based subsidiary company. It may look to the total profit of the world-wide operations of the group and claim a proportion of that total by reference to arbitrarily defined criteria. The problems associated with this technique are many and have been well rehearsed. The tax consequences are unpredictable and arbitrary. The widely varying commercial and economic climates in different countries produce inequitable results. Under this system it can lead to a demand for tax by [countries] in other parts of the world where they are already taxed, even although the local subsidiary is incurring substantial losses. On the unitary basis there is likely to be unrelieved and unrelievable double taxation. In addition the compliance costs are unacceptably high.

6. Apart from these inherent problems associated with the unitary tax basis, its incompatibility with the internationally accepted "arm's-length" basis would generate conflicts between the international investing and trading nations and disruption of international business if the precedent implicit in the Convention were to be followed by other countries. Unless common rules for determining the allocation of profits between different taxing jurisdictions are followed internationally it will be impossible to preserve the essential objective of providing a consistent and coherent international tax framework for business and investment, for which the United States and the United Kingdom have striven together with their fellow members of the Organisation for Economic Co-operation and Development. It is the view of Her Majesty's Government that the unitary basis, which is not a practical international alternative to the "arm's-length" basis, could undo the important and patient international work that has been achieved in

regulating international tax practices, and that every effort is required to discourage the use of the extension of that basis. It is to this end that the British and United States Governments have expressly prohibited its use for the purpose of the respective national tax systems under Article 9(4); and the issue will be an important aspect of the proposed annual review of the Convention.

7. Her Majesty's Government has recognised, in ratifying this Convention with the approval of the United Kingdom Parliament, and in its acceptance of the United States Senate reservation against Article 9(4) of the Convention, the difficult issues raised within the United States in seeking to limit State taxing powers through the double taxation conventions of the United States. It has also recognised the importance of the Convention in its many other aspects for the two Governments and for the business and investment communities on each side. It must be emphasized however that the acceptance of the Senate reservation in no way implies approval of the unitary basis and it is the urgent request of Her Majesty's Government for the reasons given in this Note that the Government of the United States should use its best endeavours to eliminate the international application of the unitary basis of taxation.

8. The British Embassy avail themselves of this opportunity to renew to the Department of State the assurances of their highest consideration.

British Embassy
WASHINGTON 25 March 1980

SUBMISSION DATED DECEMBER 23, 1983 FROM THE CONFEDERATION OF BRITISH INDUSTRY TO THE UNITED STATES WORKING GROUP ON WORLDWIDE UNITARY TAXATION

* * *

10 *THE COMPLIANCE BURDEN*

No Uniform Rules

10.1 The unitary States require foreign data to be converted or adjusted to the unitary State basis. Unfortunately the unitary States at present have no common rules as to how such conversion shall be done since there is no uniformity of underlying tax rules and presumably never will be so long as fiscs seek to maintain their individuality.

Disproportionate Burden on Foreign Groups

10.2 Foreign audited accounts may have to be converted into a US or local State acceptable form. Not only is this time consuming and expensive but from a businessman's point of view it becomes an exercise verging on the ridiculous if different sets of figures have to be produced to meet the whims of each local fisc.

10.3 For example, assume that UK corporation X transacts business in 20 different countries through separate subsidiaries. Clearly, these 21 corporations, including the UK parent, would not keep their books, or determine income, payroll, plant costs, and sales in United States dollars. In addition, each corporation would maintain, in local language, books and records which are consistent with the accounting standards required by its country of residence.

10.4 If X now establishes a subsidiary in a unitary jurisdiction it must be prepared to (1) translate 21 languages and (2) translate 21 currencies into United States dollars at scores of different exchange rates, all of which are subject to sharp fluctuations, devaluations, and other changes, and (3) determine what method of accounting is acceptable in the unitary jurisdiction and restate 21 sets of accounts to be consistent with that method of accounting. These adjustments could run the gamut from differences in depreciation methods to changes in tax years. Assume that the subsidiary transacts business in two different unitary jurisdictions which utilise different accounting standards. Corporation X must now prepare 42 separate sets of accounts from 21 countries. This is a situation where the cost of compliance would frequently exceed the tax at stake.

10.5 This is not a merely theoretical objection. The problem has already been acknowledged to exist, as an extract from the British Tax Review 1983, pages 206 and 207 makes clear:

> "A frank statement of one of the problems encountered in unitary taxation of foreign-based groups is contained in a memorandum dated May 31, 1979, from Dennis G Amundson, Deputy Director of the Department of Economic and Business Development of the State of California to Richard T Silberman:
>
> > "they (the staff of the Franchise Tax Board) readily acknowledged that the Board has not been able to develop an equitable method of converting foreign-based earnings into Amer-

ican dollars. This problem is greatly compounded when the foreign firm conducts operations in several countries. The distortive effect of foreign currency translation is very dramatically pointed out by Lever Brothers, a subsidiary of Unilever, N.V., a Dutch corporation, which shares a common Board of Directors with Unilever Ltd, a British corporation. In the 1976 tax year, Lever Brothers' tax obligation to the State of California . . . depends entirely on the method used to convert Dutch guilders and British pounds to American dollars and the exchange rate at the time the calculations are made. In this case, the guilder, which is very strong in relation to both the pound and the dollar, produces a substantially different picture of Lever Brothers' profitability than calculations based on the weaker pound. The staff of the Franchise Tax Board concedes that they have no existing method to deal with this problem on a uniform basis, and thus is forced to negotiate tax assessment on a case by case basis. . . ." "

10.6 We note with concern that even for one item, the translation of foreign currency, there is no common rule.

Foreign Information May not Exist or may be Secret

10.7 The situation would be difficult enough if the books and records could be produced. However, the relevant financial information may not exist at all or may reflect confidential data, trade secrets, or other information that cannot be made available for reasons totally unrelated to tax considerations.

There is no guarantee that such information will continue to be available if foreign fiscs perceive that they, and taxpayers domesticated in their jurisdiction, are being penalized by imposition of worldwide combined reporting in the USA. A company may very well be compelled to agree to any tax audit adjustment, regardless of its merit, either because the cost of contesting the adjustment is prohibitively high, or because the relevant financial information cannot readily be made available. Moreover, the cases demonstrate that the unitary state may seek to exact additional penalties for failure to provide the requested books and records.

Potential Cost of Compliance—Multiple Jurisdictions

10.8 It is already burdensome enough that information has to be kept locally according to local rules and converted as best possible for headquarters purposes. To extend this whole conversion process not just upwards towards the ultimate parent company but in all other directions also, assuming the fiscs involved in local operations jumped on the unitary bandwagon, seems patently absurd from a realistic commercial angle.

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